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No. 80-178

In the Supreme Court of the United States

OCTOBER TERM, 1979

JOHN AND NORMA OGIONY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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TABLE OF AUTHORITIES

Page

Cases:

Beran v. *Commissioner*, 40 T.C.M. (CCH) 163 6

Bolger v. *Commissioner*, 59 T.C. 760 3

Collins v. *United States*, 386 F. Supp. 17, aff'd per curiam, 514 F. 2d 1282 ..... 3, 4

Commissioner v. *Chelsea Products, Inc.*, 197 F. 2d 620 5

Grenada Industries, Inc. v. *Commissioner*, 17 T.C. 231, aff'd, 202 F. 2d 873 5

Harrison Property Management Co. v. *United States*, 475 F. 2d 623 3

Helvering v. *Lazarus & Co.*, 308 U.S. 252 4

Moline Properties, Inc. v. *Commissioner*, 319 U.S. 436 ..... 3, 4, 5

National Carbide Corp. v. *Commissioner*, 336 U.S. 422 6

Paymer v. *Commissioner*, 150 F. 2d 334 3

Strong v. *Commissioner*, 66 T.C. 12, aff'd without opinion, 553 F. 2d 94 3

United States v. *Brager Building & Land Corp.*, 124 F. 2d 349 4

Page

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.), Section 482 ..... 4, 5

N.Y. Gen. Oblig. Law § 5-501 (McKinney 1967) 2

Miscellaneous:

Rev. Rul. 75-31, 1975-1 Cum. Bull. 10 6

Rev. Rul. 76-26, 1976-1 Cum. Bull. 10 6

Treasury Regulations on Income Tax, Section 1.482-1(b)(3) (26 C.F.R.) 5

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The sole issue in this federal income tax case is whether the decision below correctly held that the net operating losses from the construction and operation of certain apartment complexes were those of its corporate owners.

The pertinent facts may be summarized as follows: Petitioners or their wholly-owned corporations formed two partnerships (Garden Partnership in 1966 and Losson Partnership in 1969) for the purpose of constructing rental apartments on certain undeveloped property in New York. They were unable to obtain loans for the apartment projects because the market interest rate for mortgage financing was in excess of the maximum rate chargeable to individuals under the usury law of New

York.[1] However, loans at a higher interest rate were available to corporations. Accordingly, petitioners decided to utilize two corporations, Garden Village Builders, Inc., and Losson Gardens, Inc., to borrow the necessary funds (Pet. App. 18-19, 31).

Garden Partnership and Losson Partnership then transferred title in the parcels of land they intended to develop to the corporations, so that the corporations became the mortgagors of record and retained title to those parcels during most of the period in question. In turn, the corporations transferred all funds obtained from the mortgage loans to the partnerships, which thereupon paid the expenses incurred in the construction and operation of the apartment projects (Pet. App. 19-20).

On their individual income tax returns, petitioners claimed distributive shares of the net operating losses reported by the partnerships. Thereafter, on audit, the Commissioner of Internal Revenue disallowed the claimed losses on the ground that they could only be claimed by the corporations and not the partnerships (Pet. App. 20). In this suit brought by petitioners for redetermination of the resulting deficiencies, the Tax Court ruled that the corporations were the proper entities to report the income and expenses generated from the construction and operation of the apartment complexes (Pet. App. 49-52). Moreover, the court rejected petitioners' contention that the deficiency determination was an arbitrary application of Section 482 of the Internal Revenue Code because the Commissioner's determinations were not based upon that provision (Pet. App. 51-52). The court of appeals

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[1]N.Y. Gen. Oblig. Law § 5-501 (McKinney 1967) limited the maximum rate chargeable to individual borrowers to 6%. In 1968, § 5-501 was amended to allow a maximum interest rate of 7 1/2%, and in 1973 a maximum rate of 8%.

affirmed. It held that " 'income from property must be taxed to the corporate owner * * * unless the corporation is a *purely passive dummy* * * *' " (emphasis in original) (Pet. App. 20). The court of appeals also rejected petitioners' Section 482 argument, agreeing with the Tax Court's disposition of that issue (Pet. App. 21-22).

1. The decision below correctly held that the losses in question were deductible only by the corporations and not the partnerships. It is well settled that if a corporation is organized for a business purpose, or if it engages in business activity, it must be recognized for tax purposes. *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). The cases following *Moline Properties* have generally held that income or losses from property properly belong to the corporate owner unless the corporation is purely passive. *Strong* v. *Commissioner*, 66 T.C. 12, 22 (1976), aff'd without opinion, 553 F. 2d 94 (2d Cir. 1977); *Harrison Property Management Co.* v. *United States*, 475 F. 2d 623, 626 (Ct. Cl. 1973); *Collins* v. *United States*, 386 F. Supp. 17, 19-20 (S.D. Ga. 1974), aff'd per curiam, 514 F. 2d 1282 (5th Cir. 1975).

Here, the corporations were clearly not passive. The formation of Losson Corporation and Garden Corporation was undertaken to circumvent the New York usury law and to secure financing. The corporations therefore served a valid business purpose, if not business necessity. See *Strong* v. *Commissioner, supra*, 66 T.C. at 24; *Collins* v. *United States, supra*, 386 F. Supp. at 21; *Bolger* v. *Commissioner*, 59 T.C. 760, 766 (1973). Moreover, the actual borrowing of funds by the two corporations was undisputably a business activity, as were their ownership of the property during construction and the discharge of their legal obligation to make the debt service payments. See *Paymer* v. *Commissioner*, 150 F. 2d 334, 336-337 (2d Cir. 1945); *Strong* v. *Commissioner, supra*, 66 T.C. at 25;

Collins v. *United States, supra.* Accordingly, under *Moline Properties* and the authorities that have followed it, Losson Corporation and Garden Corporation are separate taxable entities which are required to recognize the income and losses derived from their properties. Petitioners may not claim the losses of those corporations as their own.[2]

2. Petitioners contend (Pet. 8-10) that the Commissioner improperly allocated their claimed deductions to Losson Corporation and Garden Corporation under Section 482 of the Internal Revenue Code of 1954 without giving them notice of such allocation. Section 482 provides, *inter alia*, that the Commissioner may allocate expenses between commonly controlled organizations if he determines that such allocation is necessary to clearly reflect the income of such organizations. But no such

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[2]*Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939), and *United States* v. *Brager Building & Land Corp.*, 124 F. 2d 349 (4th Cir. 1941), upon which petitioners rely (Pet. 7-8), are not to the contrary. In *Lazarus & Co.*, this Court characterized a sale and leaseback of property for 99 years as a loan to Lazarus (the "seller") secured by the property and held that Lazarus was entitled to the depreciation deductions since it effectively bore the burden of the wasting of the business property. *Helvering* v. *Lazarus & Co., supra*, 308 U.S. at 254. Here, on the other hand, the construction loans were issued to Losson Corporation and Garden Corporation, not to the partnerships or petitioners. The corporations were obligated to repay the loans and they also bore the burden of the wear and exhaustion of the apartment complexes during the years in question. Hence, the corporations, in accordance with *Lazarus*, should be entitled to the depreciation deductions from the property.

Moreover, *Brager Building & Land Corp.* is distinguishable. There, the court ruled that the corporation involved could be disregarded for tax purposes because it, unlike Losson Corporation or Garden Corporation, had no business activities and served no business purpose. (The corporation merely held title to real estate as an agent for a partnership to avoid further complications upon the death of one of the partners.)

notice was forthcoming simply because the Commissioner did not act under Section 482 and the petitioners may not compel him to do so. See Treasury Regulations on Income Tax, Section 1.482-1(b)(3) (26 C.F.R.). As the court of appeals noted (Pet. App. 21-22):

> * * * the record is clear that the Commissioner did not invoke section 482 in denying appellants' deductions. The statutory notices do not mention the statute. Rather the Commissioner relied on the principle that the corporations, as owners of the property, were the proper parties to claim the deductions. We agree with the Tax Court that there is no reason in this case to depart from the general rule that courts will not look behind the statutory notice in order to ascertain which provisions the Commissioner relied upon in making his determination. *Branerton Corp.* v. *Comm'r*, 64 T.C. 191, 200 (1975); *Greenberg's Express, Inc.* v. *Comm'r*, 62 T.C. 324, 327 (1974). We are fortified in this conclusion by the responses of the Commissioner to interrogatories in which he repeatedly denied that his determination had been based on section 482.[3]

Moreover, even if Section 482 were invoked, the result would not be different. It would still be necessary to apply *Moline Properties* and its progeny to determine whether net operating losses should be allocated to the corporations.

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[3]Petitioners' reliance (Pet. 9-10) on *Commissioner* v. *Chelsea Products, Inc.*, 197 F. 2d 620, 624 (3d Cir. 1952), and *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, 251 (1951), aff'd, 202 F. 2d 873 (5th Cir. 1953), is misplaced because in both cases the Commissioner proceeded under the statutory predecessor of Section 482.

3. Contrary to petitioners' final argument (Pet. 12), the Commissioner's position in the instant case is not inconsistent with Rev. Rul. 76-26, 1976-1 Cum. Bull. 10, and Rev. Rul. 75-31, 1975-1 Cum. Bull. 10. In those rulings, limited partnerships were considered the owners of certain housing projects for tax purposes although title was passively held by Limited Profit Housing Corporations. These special corporations were comprehensively regulated and controlled by the state and were characterized as "agents" of the limited partnerships. Here, on the other hand, the corporations were not mere agents or nominees of the partnerships, but themselves engaged in substantial business activities (Pet. App. 49-50). See *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422, 437 (1949) (a corporation is not an agent of its shareholders by virtue of their stock ownership in the corporation).[4]

It is therefore respectfully submitted that the petition for a writ of certiorari be denied.

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Solicitor General

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[4] *Beran* v. *Commissioner*, 40 T.C.M. (CCH) 163, 168-169 (1980) (Pet. 13), is likewise distinguishable. The Tax Court there held, in part, that the shareholder was entitled to an interest deduction for amounts he paid on a "reloan" from his controlled corporation which had originally borrowed the funds from a bank on his behalf to circumvent the state usury law. It was noted that the reloan to the shareholder at the same interest rate that had been charged the corporation should be treated as a loan for tax purposes. Here, however, the borrowed funds were merely transferred, not reloaned, to the partnerships. Accordingly, any mortgage interest payments were made only on the loans issued to the corporations.

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